

Uncertainty over Trump program dominated Fed meeting

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6 January 2017

While he was not physically present at the Federal Reserve open market committee deliberations on December 13–14, nor does his name even appear in the minutes released this week, incoming US president Donald Trump was certainly a kind of *éminence grise* at the meeting.

Held some five weeks after the election amid a surge in the stock market resulting from Trump's victory, the meeting, which decided to lift the Fed's base interest rate by 0.25 percentage points, was dominated by discussion about what the new president's policies would mean for the US and indirectly the global economy.

Trump has foreshadowed major cuts in corporate and personal income tax rates, a boost to infrastructure by providing large tax write-offs for construction firms while providing them with part ownership of completed projects to provide an income stream, deregulation of finance, energy and other key areas of the economy and a strident "America first" policy on trade.

As the minutes noted, in their discussion of economic forecasts "participants emphasized their considerable uncertainty about the timing, size and composition of any future fiscal and other economic policy initiatives as well as about how these policies may affect aggregate demand and supply."

As if to underscore the lack of any clear perspective, the minutes continued: "Several participants pointed out that, depending on the mix of tax, spending, regulatory and other possible changes, economic growth might turn out to be faster or slower than they currently anticipated."

The sum of this "wisdom" is that the US economy could go up, or it could go down.

At her press conference immediately following the meeting, Fed chairwoman Janet Yellen summed up the

mood saying: "We're operating under a cloud of uncertainty at the moment."

The atmosphere of confusion was not just a product of the impact of Trump. It also reflected the realisation that the policies pursued since 2008 of pumping money into the financial system had failed to return the American economy to the rate of growth it had experienced before the financial crisis. Even before Trump's victory there was a general recognition that some change would need to be initiated.

According to the minutes, Federal Open Market Committee (FOMC) members generally agreed that an "accommodative policy," based on lower than normal interest rates, would be needed into the future and that the "neutral interest rate," defined as one that is neither expansionary nor contractionary, "still appeared to be low by historical standards" and therefore there would only be gradual rises in the future.

However there was one significant caveat to this overall outlook. As the minutes record: "Some participants noted that if the labor market appeared to be tightening significantly more than expected, it might become necessary to adjust the Committee's communications about the expected path of the federal funds rate, consistent with the possibility that a less gradual pace of increases would become appropriate."

Translating this "bankers' speak" into plain English, the Fed is looking to significantly increase interest rates and dampen any economic expansion if this brings about an increase in wages, which have been declining in real terms.

The FOMC forecast three interest rate rises this year and so far, in contrast to the situation at the beginning of 2016 when the December 2105 0.25 percentage point rise sparked considerable turbulence, the share markets appear to have taken it in stride, with the Dow

Jones Industrial Average trading near the record high it reached at the end of last year.

It could, however, prove to be a different story so far as bond markets are concerned. A rise in interest rates means a fall in bond prices (the two move in an inverse relationship to each other) and so investors who bought bonds when yields were in negative territory face significant losses as interest rates go up.

This week *Bloomberg* published an article based on research by Paul Schmelzing, a PhD candidate at Harvard University and a visiting scholar at the Bank of England, warning that if the bond market bubble bursts it will be worse than 1994, when global government bonds suffered their worst year on record.

According to Schmelzing's research, the 2016 bull market in bonds was one of the "largest ever recorded" and the market was facing a "perfect storm" because of rising yields on longer-term bonds, monetary policy tightening and the possible return of inflation. It could lead to major losses on bond holdings, subpar growth in developed economies and balance sheet risks for banks.

Another area of major concern, internationally if not yet in America, is the impact of Trump's protectionist "America first" policies on trade.

The *Financial Times* has published two worried editorials in the past week warning of the threats posed to the global trading system by the incoming president.

In the first, published on December 28, the newspaper noted that "feeble growth in world trade relative to the expansion of the global economy" had raised fears that protectionism had taken its toll and the election of Trump with his tirades against China "stealing jobs" could suggest that "the era of liberalised trade is over." The editorial called Trump's zero-sum view of the world "deeply troubling" and warned that because of the power of the American president to tear up trade deals and impose emergency tariffs "Trump could do serious damage within a relatively short period of time."

"It may be up to Congress to restrain the administration's wilder protectionist impulses—which is a little like putting the toddlers in charge of a nursery," the FT continued.

Mercantilist populism in the form of Trump could be the biggest challenge faced by the global trading system in decades. "The year of 2016 was not a disastrous one for international commerce, but it may

prove to be an uneasy calm before the trade wars begin," it concluded.

A further editorial published yesterday commented on Trump's tweet threatening Ford with a "big border tax" if it set up a plant in Mexico, leading to the cancellation of the plan.

It warned that if Trump persisted with this kind of intervention it would disrupt international supply chains and "risk stoking a protectionist and populist backlash among America's trading partners."

Trump, it said, had secured a public relations victory but his approach, even if it did not provoke trade conflict, would "introduce random and destructive political risk into the US economy" with an "America first" trade policy leaving all countries worse off.

While the *Financial Times* did not make this point, the Trump agenda is redolent of the trade war and protectionist measures of the 1930s, which, while not directly causing the Great Depression, played a major role in exacerbating its effects, including in the United States.



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